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The Euro Area on its Own—With Some Heavy Lifting to be Done

The recession in the euro area is almost officially over, but that doesn't mean the economy is back to normal—far from it. As long as no structural growth policies are enacted, the outlook for the EMU will remain grim and member states will have as much trouble meeting their fiscal targets as before. This leaves just two options open. Either Europe reverts to austerity—in which case the recovery will collapse and we'll be in for another slump with highly unpredictable consequences—or the ECB completely overhauls its policy stance. **The latest developments in the international arena make this second option increasingly likely.**

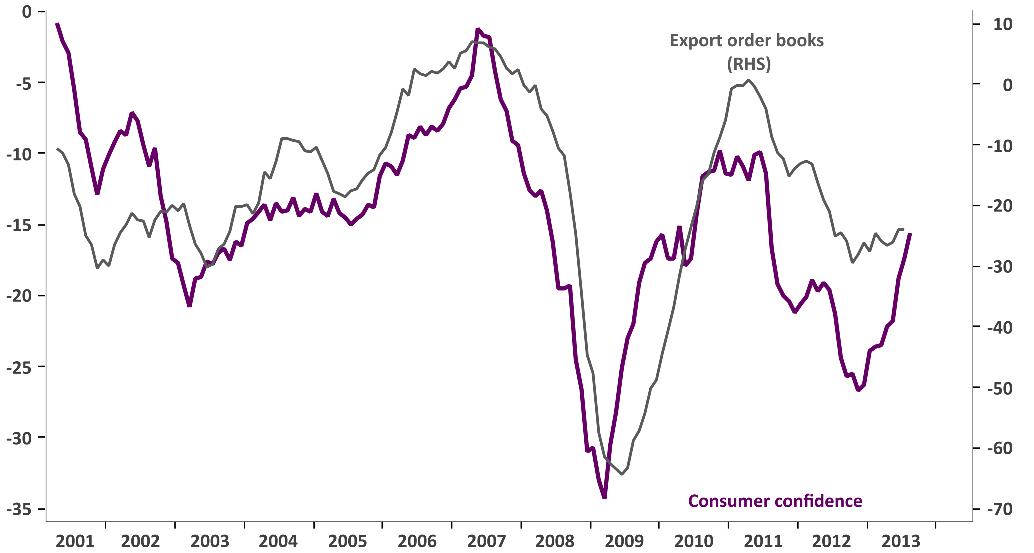
No More Recession, but No Upturn in the Cards Either

Although there were previously grounds for harboring doubts, the latest economic data clearly show that virtually all Eurozone countries are emerging from recession.

The turn away from procyclical austerity policies has begun to pay off. Even with grim economic conditions still plaguing many countries in the common currency area, consumer sentiment has risen as fiscal policy has eased. In fact, consumers are providing the most telling signs that the recessionary trend is winding down.

Consumers Show the Way in the EMU

European Commission consumer and business surveys (balances of opinion)



Sources: RichesFlores Research, Macrobond

While consumer spending is unlikely to drive growth as in the past—given how little disposable income households currently have—improved consumer sentiment suggests that domestic demand has stopped declining. That should be enough to give businesses a shot in the arm and pull the euro area out of recession by the end of the summer:

- Industrial production has picked up since the spring in most eurozone countries.
- The slide in capacity utilization rates, which precluded a recovery in industrial investment, has come to a halt.
- Although employment forecasts are still far from encouraging, they are much less alarming than a short time ago.

All this unquestionably adds up to good news, and not only for the euro area: in the past year, the entire world economy has been weighed down by the recession in Europe.

However comforting the short-term outlook may be, the European Monetary Union is still in bad shape, with considerable uncertainty on the horizon. In turning away from austerity, Europe has given up on the idea of using a deflationary shock to build competitive strength. This was clearly the wisest choice. Not only did the EMU's previous austerity policies prove devastating; they were also doomed to failure. But an alternative strategy has yet to emerge, and a number of questions on the future of the euro area are still very much on the agenda:

- How can the region's growth potential be lifted?
- Will the Southern European economies be rebuilt?
- How and when will the banking system be cleaned up?

Unless progress is made on these issues, the chances of real economic recovery will be fairly slim. Our forecast is that GDP growth in the single currency area will barely exceed 0.5 percent in 2014. Italy and Spain will just about make it to 0.0 percent, France to 0.5 percent, and Germany to 1.4 percent. (For a more detailed account, see our "Outlook 2013–2014" released in June.) This, of course, is nowhere near the figures released by the European Commission, whose analysts have predicted 1.2 percent growth in the euro area, 0.7 percent in Italy, 0.9 percent in Spain, 1.1 percent in France, and 1.8 percent in Germany.

Growth Forecasts EMU-4

Constant prices, annual change in %	2012	**2013**	**2014**	*2008-2014*
GDP Growth				
EMU	-0,4%	-0,6%	0,6%	*-0,9%*
Germany	0,9%	0,2%	1,4%	*4,3%*
France	0,0%	-0,3%	0,5%	*0,8%*
Italy	-2,4%	-1,7%	0,0%	*-7,4%*
Spain	-1,4%	-1,6%	0,0%	*-6,6%*
Private Consumption				
EMU	-1,1%	-0,4%	0,5%	*-0,07%*
Germany	0,7%	1,1%	1,3%	*6,02%*
France	-0,4%	-0,1%	0,2%	*1,84%*
Italy	-4,3%	-1,8%	0,1%	*-5,86%*
Spain	-2,1%	-2,9%	-0,3%	*-9,08%*

Source: RichesFlores Research

These numbers make it very hard to imagine that current fiscal targets can be met, particularly in countries badly bruised by the crisis and grappling with dismal domestic conditions.

So the question is what kind of economic policies we can expect: a return to austerity or a radical shift by the ECB? Developments in the international arena make this second option seem most likely.

With No Support From Emerging Economies or the Fed, the Euro Area Will Have to Do Some Heavy Lifting

The counter-intuitive austerity programs implemented in the euro area over the past three years would hardly have been possible—or even bearable—if there hadn't been adequate buffers abroad. For one thing, high growth in emerging economies could be counted on to offset some of the harm austerity would do to domestic demand, thus making the eurozone drive for competitiveness look feasible. For another, with the Fed working doggedly to ward off deflation, the ECB could afford to sit back and wait—a position that would almost certainly have been untenable without the safety net provided by U.S. monetary stimulus. No one can say what would have happened if these two counterweights hadn't been in place. With no help from abroad, the Europeans might have moved faster toward an agreement on extending deficit reduction timetables for a number of countries. And the ECB might have gone much further with the sovereign debt-buying program it gingerly tried out in 2010. Then again, things might also have turned out even worse—the European Monetary Union might well have fallen apart. But in any event, developments outside of the euro area unquestionably did a great deal to cushion the impact of a policy that was drastic across the board. Without such international backstops, the wreckage would have been even greater.

Unfortunately, those backstops are on the way out. One emerging economy after another has run out of steam in these past months, and the current situation is critical enough to have a lasting impact on international demand (see "Quand la Chine se replie sur elle-même"). Meanwhile, the Fed apparently intends to taper its unconventional monetary policy sooner rather than later. And although we doubt this will happen in the short run, a basic change of direction is clearly on the Fed's agenda. **The ramparts protecting the euro area from contraction are therefore crumbling fast, leaving the region in an increasingly vulnerable position.**

At this stage, only two basic options remain open. Europe can revert to austerity—but with international backstops no longer in place, it's a safe bet that the recovery will sputter to a halt, ushering in a new slump with unfathomable consequences. A more likely scenario, however, is that the EMU will continue with the shift in policy mix it initiated several months ago. **Today, the ECB is unquestionably better equipped than anyone else to make a difference—by cutting interest rates and expanding its balance sheet.**

Although not much is likely to happen until after the German elections, it's hard to imagine how the central bank can keep the markets on tenterhooks for long. Sooner or later, it will have to take action. Its first—and easiest—move will undoubtedly be to try to re-ignite the lending market by slashing interest rates, and more specifically by setting negative interest rates on bank deposits with the ECB. Its second move will necessarily take more time to materialize, but materialize it ultimately will. We can expect the European Central Bank to implement some sort of sovereign bond-buying program that comes with less stringent conditions than its OMT operations, which are plainly out of place in a post-austerity environment.

So notwithstanding the improved economic data for the euro area, the ECB's troubles are far from over.

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